In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 471

T. B. PEELER AND MRS. T. B. PEELER, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question in this case is whether payments petitioner [1] received for the right to mine and remove minerals on his land were capital gain, as he claimed, or depletable ordinary income, as the court below held.

Petitioner executed a "lease" that entitled the "lessee" to remove stone and sand from petitioner's land for an indefinite period, in consideration of a "royalty" of 3 cents per ton of stone removed and 2 cents per ton of sand removed, with a minimum annual payment of $800 guaranteed. The contract empowered the "lessee" to cease operations and terminate

[1] Petitioner refers to Mr. T. B. Peeler, who was the only active party in the transactions involved. His wife is a party solely because joint returns were filed.

279-625—67——1

the arrangement at any time. (R. 8–12).[2] The Commissioner's determined that these amounts be treated as depletable ordinary income. Petitioner paid the resulting deficiency and sued for a refund. The District Court sustained petitioner's contention that he was entitled to capital gains treatment of the "royalty" payments. The court of appeals reversed, holding that the payments were ordinary income subject to the depletion allowance.[3] This decision is sound and further review is not warranted.

1. Petitioner errs in his assertion (Pet. 8–9) that this Court has never determined whether cases, such as this one, that involve hard minerals, are to be governed by the same rules that this Court has developed for determining whether landowners receive ordinary or capital income in oil and gas transactions. In *Bankers Coal Co.* v. *Burnet,* 287 U.S. 308, as in the case at bar, the taxpayer had transferred operating rights in hard minerals—coal deposits—in consideration of per ton "royalty" with a minimum annual payment guaranteed. The taxpayer contended that the "royalty" payments were capital gain from a sale. This Court rejected the contention and, relying upon *Burnet* v. *Harmel,* 287 U.S. 103, a case involving oil and gas royalties, said (287 U.S. at 311):

> The considerations which led to the conclusion that bonus and royalties paid to the lessor of

[2] R. refers to the printed record in the court of appeals.

[3] The court of appeals held that this case was controlled by its decision in *Wood* v. *United States,* 377 F. 2d 300, which is also pending before this Court on petition for a writ of certiorari, No. 475, this Term. See also *Royalton Stone Corp.* v. *Commissioner,* 379 F. 2d 298 (C.A. 2), petition for certiorari pending, No. 604, this Term.

> Texas oil lands are taxable income and not a conversion of capital, as upon a sale of capital assets, are equally applicable to West Virginia coal leases, whether the title to the coal in place passes to the lessee at the date of the lease, or only upon severance by the lessee.

See also *Palmer* v. *Bender,* 287 U.S. 551, 558, and *Douglas* v. *Commissioner,* 322 U.S. 275, 280.

In these and related cases, this Court has uniformly ruled that a transfer of operating rights in minerals in consideration of payments dependent upon extraction is not a capital transaction. In the language of *Palmer* v. *Bender, supra,* the transferor in such situations does not receive capital gains if he has retained his "economic interest" in the minerals in place. Referring to the statutory provisions for depletion, the Court said (p. 557):

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

In sum, this Court has made clear that a transfer of operating rights does not terminate the transferor's "economic interest" in the minerals in place if the transferor continues to depend solely upon the extraction of the minerals for a return of his capital investment. *Commissioner* v. *Southwest Expl. Co.,* 350 U.S. 308, 314. The required dependence may take a variety of forms. Thus the decisions have found the requisite interest present when the transferor's inter-

est is payable in cash rather than kind, *Helvering* v. *Twin Bell Syndicate,* 293 U.S. 312, or represents a percentage of the gross revenue, *Burnet* v. *Harmel, supra; Palmer* v. *Bender, supra,* or of the net profits, *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commisisoner,* 328 U.S. 25. It is equally clear that the transferor receives depletable ordinary income, rather than capital gains, when, as in the present case, his receipts are a fixed amount per ton of minerals removed. *Bankers Coal Co.* v. *Burnet, supra;* see *Douglas* v. *Commissioner, supra.*

Accordingly, the Court of Appeals properly ruled that the royalty measured by quantity of stone and sand removed was depletable ordinary income to petitioner. Recent appellate decisions in four other circuits are squarely in accord. See *Royalton Stone Corp* v. *Commissioner, supra; Laudenslager* v. *Commissioner,* 305 F. 2d 686 (C.A. 3), certiorari denied, 371 U.S. 947; *Schreiber* v. *United States,* (C.A. 7), decided July 17, 1967 (20 A.F.T.R. 2d 5126); *Freund* v. *United States,* 367 F. 2d 776 (C.A. 7); *Rabiner* v. *Bacon,* 373 F. 2d 537 (C.A. 8).

2. Petitioner asserts (Pet. 6–8) in support of his petition for certiorari a conflict with the decision of the First Circuit in *Linehan* v. *Commissioner,* 297 F. 2d 276. Although the reasoning in *Linehan* is opposed to that of the Fifth Circuit in *Wood* v. *Commissioner, supra,* on which the decision in the present case is based, any resulting conflict does not warrant review of this case in this Court.

The facts of *Linehan* differ from those of this case, *Wood,* and the other cases cited above. *Linehan* involved a taxpayer who owned a piece of land of raised elevation, which he wanted excavated to a lower level. The First Circuit was apparently of the view that the substance of the agreement was that the grantee of the right to remove sand and gravel from the property was expected to excavate the property down to a level of approximately 125 feet above sea level and pay the grantor a fixed amount for each cubic yard of sand and gravel removed.[4]

In determining that the grantor's receipts were capital gains, the First Circuit relied on the statement in this Court's opinion in *Kirby Petroleum* v. *Commissioner,* 326 U.S. 599, 604 that:

> Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely on the extraction and sale of the oil.

Apparently relying on this Court's use of the phrase "and sale," the First Circuit concluded that a grantor does not receive ordinary income unless he retains a right to part of the proceeds the grantee receives for the material "after its severance," 297 F. 2d at 279. The First Circuit then concluded that because Linehan's compensation was a fixed amount per cubic yard, and had no dependence on the sale price to the

[4] The Tax Court found, and stressed throughout its opinion in *Linehan*, that the grantee was not under an obligation to remove or pay for any particular amount of sand and gravel. See 35 T.C. at 533. The First Circuit, however, made no reference to this point.

grantee, the proceeds were capital rather than ordinary.

To the extent that *Linehan* rests on the grantor's receipt of a fixed price per cubic yard it is in conflict with the decision here. But, also to that extent, the decision in *Linehan* is clearly wrong. This Court said in *Kirby Petroleum* (326 U.S. at 603):

> The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted. See *Anderson* v. *Helvering,* 310 U.S. 404, 407.

Thus, a correct analysis must be based on the grantor's interest in the mineral "in place", and not, as the First Circuit said, on the grantor's interest after severance. The issue in *Kirby Petroleum* was, moreover, whether an interest in net profits gave the grantor a right to depletion. This Court held that an interest in the net sale proceeds was a sufficient requisite to depletion, but did not hold that an interest in post-severance proceeds was a necessary element of the allowance of depletion. Were this not the correct reading, and if *Kirby* indeed supported the first Circuit's result in *Linehan,* serious questions would arise as to the continuing validity of this Court's decision in *Bankers Coal Co.* v. *Burnet, supra,* where the grantor's receipts—held to be depletable—were, as here, a per ton royalty with a guaranteed minimum annual payment. See also *Douglas* v. *Commissioner, supra.*

No court of appeals has since applied the *Linehan* rationale in any case. The Fifth Circuit in *Wood,* the Third Circuit in *Laudenslager,* and the Eighth Circuit

in *Rabiner,* has each expressly rejected the *Linehan* rationale; and in *Royalton Stone* the Second Circuit made no mention of *Linehan* in ruling against taxpayers who had expressly relied upon the case.

In addition, two decisions from other circuits on which the First Circuit relied in *Linehan, Crowell Land & Min. Corp.* v. *Commissioner,* 242 F. 2d 864 (C.A. 5), and *Barker* v. *Commissioner,* 250 F. 2d 195 (C.A. 2), have since been severely restricted in their respective jurisdictions. In *Wood* v. *Commissioner, supra,* the Fifth Circuit expressly disapproved *Crowell* to the extent that it granted capital treatment for the reason that the grantor's proceeds were based on a fixed per ton royalty. Pet. 39, n. 26; see also the instant case, Pet. 19–20, n. 2. In *Royalton Stone* v. *Commissioner, supra,* the Second Circuit restricted *Barker* to its particular facts—where the grantee agrees to pay a fixed price over a fixed period without regard to the quantity of minerals extracted.[5]

Thus the First Circuit decision in *Linehan* now clearly stands alone among appellate decisions, both in reasoning and result. The unique facts of the case by no means suggest that the First Circuit would find *Linehan* controlling in a case, such as the present one, where the agreement makes the grantor a participant in a mining venture. It could well occur that even on the precise facts of *Linehan,* the First

[5] *Gowans* v. *Commissioner,* 246 F. 2d 448 (C.A. 9), which petitioner claims to be in conflict with the Fifth Circuit's decision here and in *Wood* (Pet. 8), is a case like *Barker* where there was an obligation to pay a fixed amount and build specified facilities, regardless of the amount of minerals extracted.

Circuit would not today reach the same result. For these reasons, we submit that the difference in reasoning between this case and *Linehan* is not the sort of conflict that warrants a grant of certiorari.

3. There is nothing to petitioner's contention (Pet. 9–10) that the courts of appeals have created confusion in determining the tax treatment of a transferor's interest in hard minerals. Relying on *Hodges* v. *Georgia Kaolin Co.*, 108 Ga. App. 115, 132 S.E. 2d 86, petitioner apparently intends to reassert his argument below (see Pet. 19–20, n. 2) that Georgia law required his grantee to remove all the mineral on his property. But, as the court below recognized, *Hodges* holds only that a grantee who has removed overburden cannot stop there but must make a reasonable effort to launch profitable mining operations; it does not remotely suggest an implied obligation to mine to exhaustion.

Even if the operating company here had undertaken an obligation to remove and pay for all minerals in place, there would not have been a capital transaction. In *Burnet* v. *Harmel, supra,* this Court said (287 U.S. at p. 106):

> It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce

> the kind of hardship aimed at by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time-consuming operation and the payments made by the lessee to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.

This reasoning applies to every kind of mineral in place and every form of transfer of operating rights, so long as the grantor's consideration for the transfer is solely dependent upon extraction. The transfer in the present case falls well within that category. Further, by petitioner's own account (Pet. 5), it will take 150 years to mine the deposit involved to exhaustion, and for petitioner and his heirs to receive the "royalties" that are the return of their capital.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

RALPH S. SPRITZER,
Acting Solicitor General.
MITCHELL ROGOVIN,
Assistant Attorney General.
GRANT W. WIPRUD,
THOMAS L. STAPLETON,
Attorneys.

OCTOBER 1967.

U.S. GOVERNMENT PRINTING OFFICE: 1967